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IN THE

Supreme Court of the United States

October Term, 1973

No.

SUSQUEHANNA COAL COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The petitioner, Susquehanna Coal Company, respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on November 21, 1973.

OPINIONS BELOW

The opinion of the Court of Appeals for the Third Circuit appears in the Appendix hereto at pages 60-65. The Order of the Court of Appeals denying petitioner's Petition for a Rehearing appears in the Appendix hereto at page 67. The Memorandum Decision of the United States Tax Court appears in the Appendix hereto at pages 32-59.

JURISDICTION

The judment of the Court of Appeals for the Third Circuit was entered on November 21, 1973. A timely Petition for Rehearing was denied on December 21, 1973, and this Petition for Certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

QUESTION PRESENTED

Whether the holder of a leasehold interest in coal lands, who has acquired that leasehold interest for valuable consideration in a bargained-for exchange with an unrelated party possesses an economic interest entitling it to an allowance for depletion under 26 U.S.C. §§611 and 613.

STATUTES INVOLVED IN THE CASE

The statutes involved in this case are 26 U.S.C. §§611(a), (b)(1) and 613.

26 U.S.C. §611(a) provides in relevant part:

> In the case of mines . . . there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion . . . according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. . . .

26 U.S.C. §611(b)(1) provides in relevant part:

> In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

26 U.S.C. §613(a) provides in relevant part:

> In the case of the mines . . . the allowance for depletion under section 611 shall be the percentage, specified in subsection (b) [which is 10 percent in the case of coal], of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect to the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). . . .

REGULATIONS INVOLVED IN THE CASE

The Regulations involved in this case are Treas. Reg. §1.611-1(b)(1) and Treas. Reg. §611-1(c)(2).

Treas. Reg. §1.611-1(b)(1) provides in relevant part:

> Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits. . . .
>
> An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production.

Treas. Reg. §1.611-1(c)(2) provides in relevant part:

> In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or

other contract providing for the sharing of economic interests in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer . . . in accordance with section 613, if applicable, and the regulations thereunder.

STATEMENT OF THE CASE

INTRODUCTION

At issue is whether the Susquehanna Coal Company (hereinafter referred to as "Susquehanna") was entitled to claim an allowance for depletion under 26 U.S.C. §§611 and 613 in computing its taxable income for its taxable years ended September 30, 1962, September 30, 1963 and September 30, 1964.

It is Susquehanna's position that it acquired a leasehold interest in certain coal lands in a bargained-for exchange which entitled it to claim an allowance for depletion on its gross income from said lands. The Court of Appeals for the Third Circuit agreed that Susquehanna did acquire a leasehold interest (Appendix, page 64). However, it held that Susquehanna did not acquire the interest by "investment" as is required under the test of *Palmer v. Bender*, 287 U.S. 551 (1933) and Treas. Reg. §1.611-1(b)(1), and therefore denied Susquehanna's claim. At issue is whether Susquehanna met the "investment" requirement of *Palmer v. Bender, supra* and Treas. Reg. §1.611-1(b)(1).

It is submitted that the Court of Appeals decision is: contrary to long-standing decisional law in both this Court and other courts of appeal; contrary to long-standing Treasury Regulations; and imposes a highly restrictive burden on persons engaged in extractive industries, at a time when this country's demand for energy resources is critical, and many persons in the coal industry, such as Susquehanna, are in as depressed a financial state as the regions in which they operate. The acquisition of a leasehold interest in a bargained-for exchange with an unrelated party meets the "investment" test of *Palmer v. Bender, supra*, and Treas. Reg. §1.611-1(b)(1). The consideration paid for the leasehold interest constitutes the "investment."

STATEMENT OF FACTS

The facts are not in dispute. In 1958, L. Biscontini & Sons (hereinafter referred to as "Biscontini"), a small coal mining contractor desired to acquire certain coal lands known as the Newport lands from Glen Alden Corporation. Biscontini felt that the Glen Alden Corporation would not deal with Biscontini because of Biscontini's small size. Biscontini also needed access to a coal breaker for the processing of coal. Biscontini did not own a coal breaker and was in no financial position to build one.

Biscontini accordingly approached the M. A. Hanna Company (Susquehanna's predecessor, hereinafter referred to as "Hanna") with a proposal for the acquisition and operation of the Newport lands. Hanna, which did possess a coal breaker agreed to participate in the acquisition and operation of the Newport lands. Hanna, through its Anthracite Division, agreed to purchase the Newport lands and reconvey them to Biscontini, retaining legal title until such time as Biscontini was able to construct its own breaker.

The purchase price of the Newport lands was $1,600,000, with a down payment of $375,000 and the balance to be paid at the rate of $40,000 per year, plus 20 cents a ton for each ton mined in excess of 200,000 tons. Biscontini put up the $375,000 down payment and assumed the mortgage balance of $1,225,000. Hanna loaned Biscontini $100,000 at four percent simple interest to enable Biscontini to put up the $375,000 down payment. Biscontini subsequently paid off the $100,000 principal of the loan in full. The interest, however, was waived by Hanna.

In consideration for the services and assets of Hanna employed in the acquisition of the Newport lands Biscontini entered into a series of Agreements with Hanna defining their relationship and respective rights in the Newport lands. One of these Agreements was an "Operating Agreement" (a copy of which appears in the Appendix hereto at pages 17-31) which covered the period prior to the transfer of a deed from Hanna.

The Operating Agreement was in effect for six and one-half years, including all of the years at issue. Its original term was until August 31, 1961 but it was subsequently extended to December 31, 1964 because Biscontini was unable to construct a breaker prior to the expiration of the original term and Hanna agreed to refurbish its breaker.

In September 1961, Susquehanna acquired all of Hanna's interest in the Operating Agreement in a transaction where it purchased substantially all of the assets and assumed the principal liabilities of the Anthracite Division of Hanna for $1,500,000.

Under the Operating Agreement, Susquehanna had the right to compel and control production from the Newport lands solely for its business needs at a fixed cost per ton. Its rights under the Operating Agreement entitled it to suspend work by Biscontini for any period as Susquehanna's business required and to eject Biscontini and substitute another contractor in the event of non-performance. During the years at issue Biscontini mined coal solely for Susquehanna under the Operating Agreement.

The Operating Agreement constituted a leasehold interest in the Newport lands (Appendix, page 63).

This much is not at issue.

What is at issue is whether Susquehanna, by reason of its rights under the Operating Agreement, possessed an economic interest in the Newport lands entitling it to an allowance for depletion on its gross income from those lands less its payment to Biscontini; it being agreed that Biscontini was entitled to claim depletion on its gross income from the Newport lands.

Tax Court Decision

The Tax Court in a Memorandum Decision held that the successor to Biscontini was entitled to an allowance for depletion, but that Susquehanna was not entitled to such an allowance. The Court recognized Susquehanna's

"economic power" over Biscontini, but held that it was merely a "financier-purchaser-coal processor" and as such did not possess an economic interest. (Appendix, page 53).

Court of Appeals Decision

The Court of Appeals agreed that Susquehanna possessed a leasehold interest in the Newport lands but denied its claim for depletion on the ground that only Biscontini (and its successor) had made an investment in the mineral in place. The apparent basis for this conclusion was the Court of Appeals finding that Susquehanna could recover its expenditures by means other than depletion.

The Court of Appeals denied a timely Petition for Rehearing on this issue.

REASONS FOR GRANTING THE WRIT

The Court of Appeals erred in holding that while Susquehanna had acquired a leasehold interest in the coal lands in a bargained-for exchange it did not acquire such interest by "investment" and therefore was not entitled to an allowance for depletion.

The requirements for claiming an allowance for depletion were set forth by this Court in *Palmer v. Bender*, *supra*. A taxpayer will be entitled to an allowance for depletion if it has an economic interest in the mineral in question. An economic interest exists whenever a taxpayer has acquired by investment any interest in mineral in place and secured by any form of legal relationship income derived from the extraction of the mineral to which he looks for a return of his capital. These requirements are also set forth in the Treasury's Regulations and have been followed in numerous cases of this Court. See, e.g. *Helvering v. Bankline Oil Co.*, 301 U.S. 362 (1938); *Burton Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946); *Commissioner v. Southwest Exploration Co.*, 350 U.S. 30 (1956), and Treas. Reg. §1.611-1(b)(1).

It is well established that a lessee of mineral lands who has acquired the leasehold interest by the exchange of mutual convenants possesses a sufficient interest to entitle it to an allowance for depletion. *Palmer v. Bender, supra; Night Hawk Leasing Co. v. Burnet*, 57 F.2d 612 (D.C. Cir. 1932); *Charles P. Mullins*, 48 T.C. 571 (1968); *Eastern Coal Corp. v. Yoke*, 67 F. Supp. 166 (N.D. W.Va. 1946); *Haddock Mining Co. v. United States*, 92 F. Supp. 106 (M.D. Pa. 1950). Where both the lessor and lessee possess economic interests in the same mineral lands, it is statutorily mandated that there be an equitable apportionment between them. 26 U.S.C. §611(b)(1).

It is also well established that an investment can be in a form other than cash, and that the exchange of mutual covenants, the performance of services or the conferring of other economic benefits will constitute an investment. Thus, in *Palmer v. Bender, supra*, the consideration paid for the taxpayer's leasehold interest was its covenant to drill test wells on the leased property and to make rent and royalty payments. This Court noted, supra, at 558:

> Even though legal ownership of it, in a technical sense, remained in their lessor, they as lessees nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under this statute.

In *Night Hawk Leasing Co. v. Burnet, supra*, the consideration for the leasehold interest was certain mutual covenants.

The Court of Appeals for the District of Columbia Circuit in rejecting the commissioner's contention that the lessee did not possess a depletable interest stated:

> This contention, however, is made inapplicable to the present case by the concluding provision of each of these statutes, reading as follows: 'In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee.' * * * "Accordingly, if the owner of a claim

> be entitled under any one of these provisions to a depletion deduction in case the claim is operated by him alone, such deduction shall be equitably apportioned between such owner and lessee if the claim be operated by a lessee. This is the case regardless of whether the lease was acquired by the lessee prior to March 1, 1913, or subsequent to that date without 'acquisition cost, advance royalty, or bonus,' and without discovery by the lessee. The equitable interest of the lessee in the leased mine, upon which the depletion allowance depends, results from the mutual covenants of the parties in the lease. The lessee thereby acquired certain property rights in the mine. (57 F.2d 612, 13).

In *Rev. Rul.* 56-542, 1956-2 C.B. 327, 328, the Internal Revenue Service in defining economic interest stated:

> Second, the right must stem from an investment. Investment means the acquisition of a direct *equity* in the ore . . .

The Court of Appeals held in this case, however, that while Susquehanna had obtained a leasehold interest from an unrelated party in an arm's length transaction, it had made no investment in the Newport lands. Under the Court's view, the only expenditures made by Susquehanna were the $100,000 loan to Biscontini and the refurbishing of a breaker, both of which were recoverable from sources other than the Newport lands; the loan was repaid and the costs of refurbishing the breaker could be recovered through depreciation deductions.

The Court of Appeals decision applied a strict "cash expenditure" test in order to satisfy the "investment" requirement of *Palmer v. Bender, supra,* and Treas. Reg. §1.611-1(b)(1). The services performed by Hanna in acquiring the Newport lands and Hanna's covenants under the Operating Agreement, as well as the value of the loan and the use of the breaker to Biscontini were held by the Court of Appeals to be insufficient to constitute an investment.

The Court of Appeals was in error. The consideration that supported the acquisition of the Operating Agreement met the investment requirements of *Palmer v. Bender, supra*. Biscontini required certain assets and services from Hanna in order to enable it to purchase the Newport lands. In exchange for these assets and services Biscontini gave Hanna a leasehold interest in the Newport lands. Hanna's investment in the Operating Agreement included its services in acquiring the lands, the making of a loan to Biscontini, refurbishing and making available its breaker and its obligations under the Operating Agreement.

The fact that the advance from Hanna to Biscontini was regarded as a loan and that the breaker could be depreciated is legally irrelevant in determining whether an investment was made.

With respect to these two items, the consideration paid to Biscontini for the Operating Agreement was simply the excess of the value of the loan over Biscontini's obligation to repay it at some future date and the value of the breaker to Biscontini in excess of the benefit of cost recovery through depreciation by Susquehanna.

That Biscontini conferred a leasehold interest upon Susquehanna is objective evidence of the existence of a value Susquehanna transferred to Biscontini which would not be recovered by Hanna through a means other than the Newport lands. Under the Court of Appeals' analysis, the receipt of a fee simple in mining lands in exchange for the making of a loan would not entitle the lender to claim depletion in the fee because no investment was made in the real estate.

Cases such as *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1965) and *Parsons v. Smith*, 359 U.S. 215 (1959), relied upon by the Court of Appeals in its November 21, 1973 decision are not controlling since they dealt with the rights of mining contractors and not with the rights of a lessee. The crucial distinction between those cases and the instant case is that in the instant case the owner, Biscontini, by virtue of the transfer of the leasehold

interest to Susquehanna under the Operating Agreement, transferred a capital interest to Susquehanna. Susquehanna was the owner of the coal in place during the term of the Operating Agreement; Biscontini performed mining services as a contractor for Susquehanna, and such services involved the mining of coal solely for Susquehanna's business requirements. In *Paragon* and *Parsons*, the mining contractors had no such interest in the coal in place. They merely performed mining services for the owner (a lessor) at a fixed price per ton for their services. See *Charles P. Mullins, supra.* Likewise, in *Helvering v. Bankline Oil Co., supra,* the taxpayer could not compel and control production. The ability of Susquehanna, as lessee, to compel and control production of the coal distinguishes this case from *Helvering v. Bankline Oil Co., supra.* Indeed, since Susquehanna had the right to control and compel production by virtue of the Operating Agreement, *Helvering v. Bankline Oil Co.*, supports Susquehanna's position.

In *Helvering v. Bankline Oil Co., supra,* this Court specifically stressed that Bankline "had the right to have the gas delivered, but did not produce it and could not compel its production."

> . . . [Bankline] had no enforceable rights whatsoever under its contracts prior to the time the wet gas was actually placed in its pipe line, i.e., after it has passed beyond the casingheads and gas traps supplied by the producer into the pipe line, except the right, perhaps, to demand that the producer deliver whatever was produced through its pipe lines for treatment during the period of contractual relationship. *Helvering v. Bankline Oil Co., supra,* at p. 368.

The controlling fact was that Bankline had no interest in the gas in place; it had no capital investment in the mineral deposit which suffered depletion (supra at p. 368). In the instant case, the facts show beyond any doubt that so long as the Operating Agreement was in effect, Susquehanna had enforceable rights to the coal from the Newport

lands prior to the time the coal left the mine and could both compel and control production of that coal solely for its needs. Susquehanna's interest was in the coal at every point in the extraction process. For the duration of the Operating Agreement, Susquehanna not only had the right to have all the coal from the Newport lands mined for it but it could compel production from a contractor who could mine solely for Susquehanna, and in the event of non-performance could be ejected by Susquehanna and replaced by another contractor.

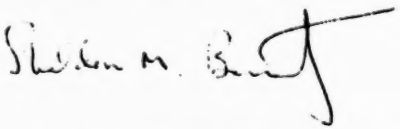
Thus, Susquehanna acquired a leasehold interest with full rights to the coal in place from Biscontini. This leasehold interest, which is unquestionably an equity or capital interest in the coal, was acquired for valuable consideration, including the use of its services and assets in the acquisition of the Newport lands. The value of these services and the legal detriment Hanna incurred could only be recovered by the exercise of its rights under its leasehold interest.

The Court of Appeals by concentrating on the fact that the out of pocket breaker costs could be recovered through depreciation and that the principal of the loan was payable from general sources overlooked the economic value to Biscontini, and the corresponding detriments to Hanna, of the services provided by Hanna in the acquisition of the Newport lands, Hanna's obligations under the Operating Agreement, the use and refurbishing of Hanna's breaker for coal production on the Newport lands, and the loan of approximately 30 percent of the necessary down payment to purchase the Newport lands.

CONCLUSION

For all of the foregoing reasons, Petitioners respectfully request this Honorable Court to grant a Writ of Certiorari upon the United States Court of Appeals for the Third Circuit.

Respectfully submitted,



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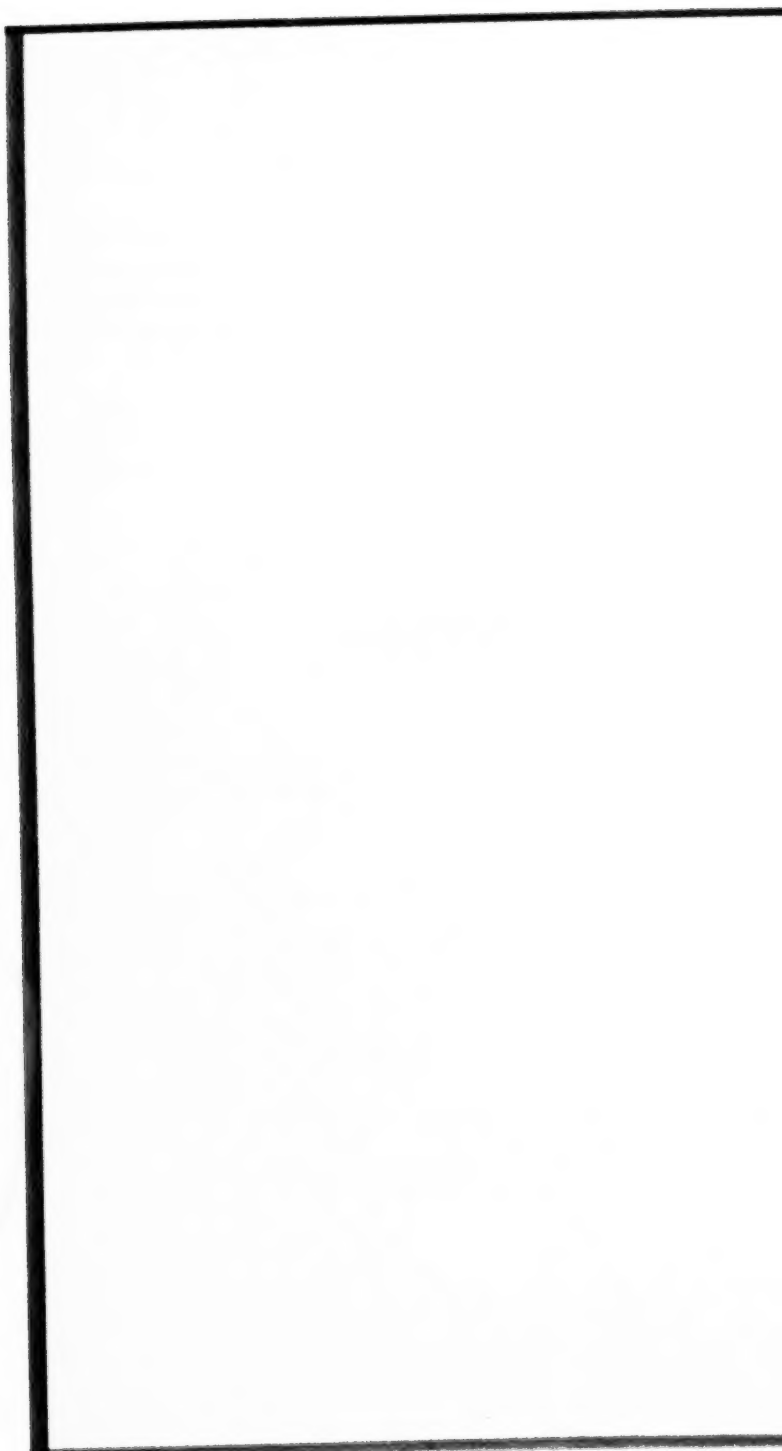
APPENDIX



OPERATING AGREEMENT

THIS AGREEMENT, made this 17th day of June, 1958, between L. BISCONTINI & SONS, of the City of Nanticoke, Luzerne County, Pennsylvania, party of the first part, hereinafter called "Contractor",

AND

SUSQUEHANNA COLLIERIES DIVISION, THE M. A. HANNA COMPANY, with office and business in the City of Nanticoke, Luzerne County, Pennsylvania, party of the second part, hereinafter called "Susquehanna",

WITNESSETH:

ARTICLE I

Contractor, for and in consideration of the unit prices hereinafter stipulated to be paid to it by Susquehanna, as well also for and in consideration of the faithful performance by Susquehanna of the covenants and agreements hereinafter mentioned to be performed and kept by Susquehanna, hereby convenants and agrees with Susquehanna as follows:

1. That Contractor will at its own cost and expense dig, mine and remove the coal from certain veins about to by conveyed to The M. A. Hanna Company by Glen Alden Corporation, in Newport Township, Luzerne County, Pennsylvania.

2. That Contractor will load into auto trucks such of the coal from said area as shall be reasonably free and clean of all rock, direct and refuse and deliver same to the Glen Lyon breaker.

3. That Contractor will, at its own expense and cost, provide, furnish, and maintain auto trucks, machinery, tools, equipment, appliances, supplies and labor necessary, adequate and sufficient for the full, punctual, prompt, faithful and diligent performance of its part of this Agreement.

4. That Contractor will use all reasonable diligence in the prosecution of the work of digging, mining, hoisting, trucking and removing said coal and will do and perform the work in a safe, good and workmanlike manner and in accordance with the best known and approved practice and methods.

5. That Contractor will, at all times use reasonable care and precaution in the digging, mining, cleaning, removal, leading and transportation of said coal so as to prevent waste of said coal.

6. That Contractor will, at the request of the General Superintendent, or his authorized representative, and at its own cost, recover and reclaim all coal deposited upon the refuse banks and dispose of same as directed by the said General Superintendent or his duly authorized representative.

7. That Contractor will, whenever and as often as it becomes necessary, pump, at its own cost and expense, the water from the workings opened by it, and will provide, build, construct and maintain the necessary means for disposal of all water so pumped or any other water that may be necessary for it to dispose of in conjunction with its operations under this Agreement.

8. That Contractor hereby assumes every and all liability and responsibility for any and every and all accidents, injuries and damages of every sort and kind that occur to or are suffered by any of its agents, servants, employees, invitees, and to any and all other person or persons, including the officers, agents, servants, employees and invitees of Susquehanna, and to any and all tangible property by whomsoever owned or possessed, in, upon, about, adjacent, or at a distance from, every and all places where it is performing or has performed or is doing or has done, or is permitting or has permitted, or is suffering or has suffered, anything to be done or performed or undertaken, or attempted to be done or performed or undertaken,

which is connected with or related or incidental to the performance of its part of the Agreement, and does hereby agree to indemnify and save harmless Susquehanna from any and all costs, expenses, actions, suits, claims and demands whatsoever, at law or in equity, arising therefrom, whether by any act of commission or omission, and will, before the commencement of any work under this Agreement, take out and submit to the General Superintendent of Susquehanna, or his duly authorized representative, a policy or policies of insurance protecting and insuring it against such liability and responsibility, together with receipt showing payments of premiums for same.

9. That Contractor will at all times obey all laws of the United States and of the State of Pennsylvania applicable to the performance of its part of this Agreement, and will accept the provisions of The Pennsylvania Workmen's Compensation Act, approved June 21, 1939, P. L. 520, and its supplements and amendments, and The Pennsylvania Occupational Disease Act, approved June 21, 1939, P. L. 566, and its supplements and amendments, and will insure and keep insured its liability under each of said Acts, and will, before the entry upon the premises hereby demised and the commencing of any work under this Agreement, submit to the General Superintendent of Susquehanna, or his duly authorized representative, a certificate showing insurance of its liability under each of said Acts, together with receipt showing payments of premiums for same. Contractor hereby agrees that it will pay all taxes, levies and assessments punctually as provided by the Federal Social Security Act, and the Unemployment Compensation Law of Pennsylvania, approved December 5, 1936, P. L. 2897, and the supplements thereto and amendments thereof.

10. That Contractor will not assign, sublet, transfer nor encumber this Agreement, or any part thereof, in any way or manner whatsoever, without the written consent of the General Superintendent of Susquehanna. No consent

shall be deemed a general waiver of the provisions of this paragraph, but shall be limited to the transfer, assignment or sub-letting specifically named in the consent.

11. That Contractor will not hold Susquehanna liable for any losses or damages resulting to it from delays caused by strikes of employees of Susquehanna, or for any cause or causes whatsoever beyond the control of Susquehanna.

12. That Contractor will, at its own expense and costs, dump all rock or refuse resulting from its operations under this Agreement at such place and in such manner as the General Superintendent of Susquehanna, or his authorized representatives, may direct.

13. That Contractor shall not do any extra work or work unprovided for in this Agreement unless directed to do so in writing by the General Superintendent of Susquehanna, and no claim or claims for extra work or work unprovided for shall be allowed unless done in accordance with such written direction.

ARTICLE II

IT IS MUTUALLY COVENANTED AND AGREED by and between the parties hereto as follows:

1. That Susquehanna reserves the right, by its General Superintendent, engineers, mine foremen or agents, at all times to visit, inspect and survey the premises upon which Contractor is conducting any work under this Agreement for any and all purposes deemed desirable, and nothing shall be done or permitted or suffered to be done by Contractor which is detrimental to Susquehanna, or said premises, or other premises or property of Susquehanna.

2. Contractor hereby agrees to do all work of every nature and description which is required or is proper for the mining and stripping of the coal on the property abovementioned at its own costs and expense and also to do all timbering, track work, pumping, recovering, relaying and

grading track and all other items of work that may be necessary for the safe and efficient mining of the coal covered by this Agreement.

3. The Contractor, at its own cost and expense, will furnish the labor and materials for, and make, build and maintain all roads and ways of ingress, egress and regress required by it upon aforesaid lands in the performance of its part of this Agreement.

4. If the union scale of wages prevailing at the time of the dating of this Agreement is changed during the existence of this Agreement, it is mutually agreed as follows:

(a) That if the union scale is increased, Contractor shall be reimbursed by Susquehanna for the additional wages paid.

(b) That if the union scale is decreased, Contractor shall reduce the unit price by an amount equal to the decrease in wages paid.

(c) Contractor agrees that full inspection of its records and books to determine (a) or (b) shall be given to the authorized representative of Susquehanna.

5. That if at any time during the existence of this Agreement the General Superintendent of Susquehanna, or his authorized representative, shall decide that the unmined coal in the aforesaid areas is not of sufficient value to make further mining thereof desirable to Susquehanna, then, in such case, he may give Contractor two weeks' written notice to cease all work under this Agreement, and this Agreement shall be terminated and ended at the expiration of said two weeks' notice.

6. That the General Superintendent of Susquehanna, or his authorized representative, shall have the right to suspend the work being done by Contractor under this Agreement for any indefinite period or periods, as the exigencies of Susquehanna's business may require, without liability to Contractor therefor, but will, however, endeavor

to give Contractor notice of such suspension as soon prior thereto as he can reasonably do so.

7. In the event that work under this Agreement is interrupted or suspended for causes beyond the control of either party hereto, then this Agreement shall be suspended for a time reasonably required to adjust, remedy or rectify said cause or causes and in case the time required for so doing is prolonged for a period of more than thirty days either party may thereupon terminate this Agreement.

8. That in case Contractor shall fail to prosecute the work with adequate equipment and/or sufficient force of men and materials, the General Superintendent of Susquehanna, may, at his discretion, give Contractor thirty days written notice to provide same, and if Contractor, at the expiration of thirty days, continues to be delinquent in compliance with said notice, then the General Superintendent of Susquehanna may declare this Agreement forfeited and at an end, and Susquehanna may forthwith enter upon and take possession of the premises occupied by Contractor without lot or hindrance on the part of Contractor.

9. That upon the termination of this Agreement in any way or from any cause or causes, Contractor agrees that it will quietly and peaceably surrender to Susquehanna the possession, use and occupancy of and vacate and move from the whole of the premises occupied by it under this Agreement.

10. In the event that work by Contractor under this Agreement for any cause or causes is suspended, and at the time of suspension Contractor has coal at the aforesaid areas ready for loading and delivery, then, in such cases, the General Superintendent of Susquehanna may, at his discretion, permit Contractor to remove, load and deliver such coal, and Susquehanna, in such case, will take and pay for all of said coal properly delivered as in this Agreement provided.

11. That all disputes concerning the performance by Contractor of its part of this Agreement shall be referred to and determined by the General Superintendent of Susquehanna, whose judgment in the premises shall be final and conclusive and binding upon Contractor.

12. That any notice in writing in relation to any matter mentioned in this Agreement, addressed to Contractor, and left upon the premises with the Superintendent, manager, clerk or other person in charge for Contractor, or of the office, or if there be no one in charge or in the office, posted on the premises, shall have the same force and effect as if served personally upon Contractor.

13. Contractor will, during the existence of this Agreement, endeavor to deliver to Susquehanna a minimum of the equivalent of 925 mine cars of coal for each day the Glen Lyon Colliery Breaker works, and as much more as is mutually agreed upon by Contractor and Susquehanna.

The method to be used for computing the amount of money which Contractor shall be paid under this Agreement shall be determined in the following manner:

Contractor and Susquehanna by mutual agreement will determine from time to time the capacity in cubic feet of the required coal as specified in Paragraph 2 of Article I hereof, of each truck loaded by Contractor, which trucks are to be uniformly loaded, and of such total cubic feet of material delivered each one hundred (100) cubic feet thereof will be considered as yielding a mine car of the required coal as heretofore specified, which said mine car shall be and constitute the unit for computing the amount of money which Contractor shall, at the price per car hereinafter stipulated, be paid by Susquehanna for the full and complete performance by Contractor of its part of this Agreement.

The General Superintendent of Susquehanna, and/or his authorized representative, shall at all times have the full and exclusive right and power of determining in their own way which trucks have been properly loaded by Contractor and which have not, and they and each of them shall

have the full right and power of rejecting, in whole or in part, any and every truck which, in the judgment of them or either of them, is not properly loaded with the required coal as heretofore specified, or which contains excessive earth, rock or refuse, and the decision of them, or either of them, of these questions shall be final, conclusive and binding upon Contractor, and only such trucks or parts of trucks of coal which have not been rejected as aforesaid shall be considered as accepted by Susquehanna.

14. In all cases where, in this Agreement, the approval or direction of Susquehanna or its authorized representative is required, it is expressly understood and agreed that such requirement is of approval only and not of control or management and that Susquehanna, or its authorized representative, shall not incur any responsibility or liability by reason of such approval or direction to Contractor.

15. If at any time or times Contractor shall not keep and perform all of the covenants, agreements, conditions and obligations, and observe all the terms, provisions and restrictions of this Agreement on its part to be kept, performed and observed, or shall violate any of them, or shall suffer any mechanic's lien to be entered against the aforesaid area or against buildings or machinery now or hereafter erected therein, or execute any mortgage thereof, or make any assignment for the benefit or creditors or composition with creditors which shall include such property, or shall suffer any judgment to be entered against it beyond what its other property is amply sufficient secure and pay, or if Contractor shall be judicially declared bankrupt or insolvent under or by virtue of any proceedings in bankruptcy or insolvency in either the Federal or State Courts, or if a petition for the reorganization under the Federal Bankruptcy Act be approved by the Court, or if Contractor shall make an assignment for the benefit of creditors, or shall file a petition in bankruptcy or insolvency, or for reorganization, or if a petition under any chapter of the Bankruptcy Act shall be filed by or against the Contractor, or any

petition for the appointment of a receiver or trustee of all or a portion of its property shall be filed by or against it, or if it shall do any other act by which any other person or persons or corporations may or shall claim to be the owner or owners in whole or in part, or to have any control over the aforesaid area, fixtures or personal property connected therewith or used thereon for the purpose herein set forth, without the consent of Susquehanna in writing first had and obtained, then, and from thenceforth, in any or either of such cases, Susquehanna may, at its option, give notice to contractor upon the said area, or if not there found to post the said notice thereupon in some conspicuous place, that it annuls and makes void this Agreement and the privileges hereby granted, and thereupon this Agreement and the privileges shall cease and determine and become void, and Susquehanna may enter upon the said area and seize and take possession of for its own use the said area and all the machinery, fixtures and other improvements, and all personal property of every description found thereon, as its own property, anything herein contained to the contrary thereof notwithstanding.

16. Contractor hereby agrees that when this Agreement shall be terminated by notice or otherwise, it shall be lawful for any attorney of any court of record in the State of Pennsylvania to appear for the Contractor and to sign an Agreement for entering in any competent court in said County of Luzerne an amicable action of ejectment to be therein brought by Susquehanna for the recovery of all the premises in the possession, use and occupancy by Contractor under this Agreement, and therein confess judgment in ejectment without any stay of execution against Contractor, and with waiver and release of all errors in the said judgment, or any process or proceedings thereon, for which this shall be a sufficient warrant; whereupon, if Susquehanna, its successors or assigns, so desires, a writ of habere facias possessionem may issue forthwith, without any prior writ or proceedings whatsoever, together with a fi.fa. for costs, Contractor hereby releasing and agreeing

to release Susquehanna, its successors and assigns, from all errors and defects whatsoever in entering said action or judgment, or causing such possessory writ to be issued, or in any proceedings thereon or concerning the same, and hereby agreeing that no writ or error or objection or exception shall be made or taken thereto; provided that Susquehanna, its successors or assigns, shall first cause to be filed in such action an affidavit, made by someone on its or their behalf, setting forth the facts necessary to authorize the entry of such judgment, of which facts such affidavit shall be conclusive evidence, and if a true copy of this Agreement (and of the truth of the copy such affidavit shall be sufficient evidence) shall be annexed to such affidavit it shall not be necessary to file the original as a warrant of attorney, any rule of court to the contrary notwithstanding and provided, further, that if for any reason after any such action has been commenced the same shall be determined and the possession of the premises remain in or be restored to Contractor, Susquehanna, its successors or assigns, shall have the right, in the event of any subsequent termination or terminations, to bring one or more further amicable actions in manner and form as hereinbefore set forth to recover possession of said premises upon such subsequent termination or terminations.

ARTICLE III

Susquehanna hereby covenants and agrees with Contractor as follows:

That in consideration of the faithful performance by Contractor of the covenants and agreements herein to be kept and performed by it, Susquehanna will pay or cause to be paid unto Contractor the following:

The sum of Eighteen Dollars ($18.00) for each and every 100 cubic foot mine car from all underground mining, each car to yield the minimum of 70% commercial coal of No. 3 Buckwheat and above, delivered and dumped at the Glen Lyon Breaker.

The sum of Eighteen Dollars ($18.00) for each and every 100 cubic foot mine car of stripping coal put through the present cleaning plant on Glen Alden property, each car yielding a minimum of 70% commercial coal of No. 3 Buckwheat and above to be delivered and dumped at the Glen Lyon Breaker.

Payments to Contractor under this Agreement are to be made in the following manner, to wit:

On or before the first and sixteenth days of each calendar month during the existence of this Agreement, Susquehanna will cause to be prepared a statement setting forth the number of cars of coal delivered to it by Contractor during the preceding half-month, and the amount payable to Contractor therefor, and said amount shall be paid to Contractor within fifteen days next following the last day of the period covered by said statement, which shall be payment in full to contractor for everything in relation to this contract up until the end of such period, and no further claim or demand shall be made upon Susquehanna therefor or in connection therewith, it being understood that all premium, fringe and vacation payments are covered by and included in the aforementioned unit prices under this Agreement.

That Susquehanna will not hold Contractor liable for any losses or damages resulting from delays caused by strikes of employees of Contractor, or for any cause or causes whatsoever beyond the control of Contractor.

It is mutually agreed between the parties hereto that, in the event of forbearance by Susquehanna, or of its failure to enforce any of the provisions of this contract, or of its acceptance from Contractor of a lessor of different measure of performance than is hereinbefore provided, for any period of time, such acceptance or forbearance on the part of Susquehanna shall not operate or be construed as a waiver or change of any of the provisions of this contract, but may be enforced as Susquehanna may determine, unless otherwise agreed to in writing between the parties.

ARTICLE IV

Contractor agrees to reimburse Susquehanna on the first day of September, 1958, for one third of the real estate taxes for 1958, and on the first day of January, 1959, and quarterly thereafter to pay to Susquehanna one quarter of the taxes for the then current year based on the previous year's taxes which shall be adjusted within thirty (30) days after the tax bills are actually received.

Contractor agrees to also pay to Susquehanna $10,000.00 quarterly on the 20th day of each December, March, June and September, in each year plus $0.20 per gross ton for each and every gross ton over 50,000 gross tons of commercial coal mined and sold from the property in that quarter year, said payments to be made on the 25th day of December, March, June and September for coal mined and sold in the preceding quarter.

PROVIDED, if in any quarter of the year during the life of this Agreement Contractor shall have mined a less number of gross tons than is sufficient at the above $0.20 per gross ton to make up the quarterly installments as aforesaid, the Contractor may in any future year or years mine and remove sufficient coal at $0.20 per gross ton to reimburse itself for the coal so paid for and not mined and removed and without further payment therefor.

This Agreement shall expire on August 31, 1961.

THIS AGREEMENT shall be binding upon and inure to the benefit of the successors and assigns of the parties hereto, and the parties hereto intend to be legally bound by this Agreement regardless of the consideration.

IN WITNESS WHEREOF, the said L. BISCONTINI & SONS have hereunto set their hand and seal, and Susquehanna Collieries Division, The M. A. Hanna Company, has caused this Agreement to be signed by its President, for and on its behalf, the day and year first above written.

WITNESS:

_____ _____

_____ _____

_____ _____

SUSQUEHANNA COLLIERIES DIVISION,
THE M. A. HANNA COMPANY

By:

_____
President

APPROVED AS TO FORM

_____

STATE OF PENNSYLVANIA

SS:

COUNTY OF LUZERNE

On this, the 17th day of June, 1958, before me, a Notary Public, the undersigned officer, personally appeared Laurence Biscontini, who acknowledged himself to be a Partner of L. BISCONTINI & SONS, and that he as such Partner executed the foregoing instrument for the purposes therein contained.

IN WITNESS WHEREOF, I hereunto set my hand and official seal.

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Notary Public

STATE OF PENNSYLVANIA

SS:

COUNTY OF LUZERNE

On this, the 17th day of June, 1958, before me, a Notary Public, the undersigned officer, personally appeared Arnold Biscontini, who acknowledged himself to be a Partner of L. BISCONTINI & SONS, and that he as such Partner executed the foregoing instrument for the purposes therein contained.

IN WITNESS WHEREOF, I hereunto set my hand and official seal.

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Notary Public

STATE OF PENNSYLVANIA

SS:

COUNTY OF LUZERNE

On this, the 17th day of June, 1958, before me, a Notary Public, the undersigned officer, personally appeared Albert Biscontini, who acknowledged himself to be a Partner of L. BISCONTINI & SONS, and that he as such Partner executed the foregoing instrument for the purposes therein contained.

IN WITNESS WHEREOF, I hereunto set my hand and official seal.

_____

Notary Public

STATE OF PENNSYLVANIA

SS:

COUNTY OF LUZERNE

On this, the 17th day of June, 1958, before me, a Notary Public, the undersigned officer, personally appeared who acknowledged himself to be the President of SUSQUEHANNA COLLIERIES DIVISION, THE M. A. HANNA COMPANY, a corporation and that he as such President being authorized to do so, executed the foregoing instrument for the purposes therein contained and in the capacity therein stated, by signing the name of the corporation by himself as President.

IN WITNESS WHEREOF, I hereunto set my hand and official seal.

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Notary Public

Memorandum Decision
of
Tax Court

T. C. Memo. 1972-189

UNITED STATES TAX COURT

GAP ANTHRACITE CO., ET AL.,[1] *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket Nos. 726-68, 727-68, 5032-68, 4407-69.

Filed August 29, 1972.

Sheldon M. Bonovitz and *Ronald F. Kidd*, for the petitioners in Docket Nos. 726-68, 727-68, and 4407-69.

Merle A. Wolfson, *Michael R. Harris*, and *Andrew Hourigan, Jr.*, for the petitioner in Docket No. 5032-68.

Edward L. Newberger, for the respondent.

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1. Cases of the following petitioners are consolidated herewith: *Grant Anthracite Co.*, Docket No. 727-68; *Glen Nan Coal Co.*, Docket No. 5032-68; *Susquehanna Coal Company*, Docket No. 4407-69.

MEMORANDUM FINDINGS OF FACT AND OPINION

TANNENWALD, *Judge:* Respondent determined the following income tax deficiencies in these consolidated cases:

Docket No.	Petitioner	Taxable year ended	Deficiency
726-68	Gap Anthracite Co.	12/31/61	$ 1,653.93
		9/30/62	151,839.98
		9/30/64	16,114.61
727-68	Grant Anthracite Co.	12/31/61	5,366.04
		9/30/62	142,854.34
5032-68	Glen Nan Coal Co.	6/30/63	184,335.51
		6/30/64	242,851.92
		6/30/65	78,240.84
4407-69	Susquehanna Coal Co.	9/30/62	403,784.58
		9/30/63	55,920.81

Due to the extensive efforts of the parties, most of the issues in these cases have been settled and most of the facts relating to the disputed issues have been stipulated. The two questions remaining for our consideration are: (1) whether either, neither, or both petitioners in Docket Nos. 5032-68 and 4407-69 have an economic interest in certain coal-producing property so as to permit the taking of a deduction for depletion with respect to that property; and (2) whether the petitioners in Docket Nos. 726-68 and 4407-69 changed their method of accounting with respect to an allegedly material item without the Commissioner's consent.[2]

GENERAL FINDINGS OF FACT

Some of the facts have been stipulated and are incorporated herein by this reference.

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2. Although all issues in Docket No. 727-68 have been resolved, the parties have asked that decision not be entered therein until decision is rendered in Docket No. 4407-69; we assent to this request.

Glen Nan Coal Co., Inc. (hereinafter referred to as Glen Nan) is the original petitioner in Docket No. 5032-68[3] and had its principal place of business in Wilkes-Barre, Pennsylvania, at the time of the filing of its petition herein. At all times pertinent hereto, Glen Nan and its predecessor-in-interest, L. Biscontini & Sons (hereinafter referred to as Biscontini), a partnership, were engaged in mining coal from certain lands henceforth referred to as the Newport Lands.

For the fiscal year ended June 30, 1963, Glen Nan timely filed its Federal income tax return with the district director of internal revenue at Scranton, Pennsylvania. For the fiscal years ended June 30, 1964 and June 30, 1965, Glen Nan timely filed such returns with the district director of internal revenue at Philadelphia, Pennsylvania.

Susquehanna Coal Company (hereinafter referred to as Susquehanna), the petitioner in Docket No. 4407-69, had its principal place of business in Nanticoke, Pennsylvania, at the time of the filing of its petition herein. At all times pertinent hereto, the corporation was engaged primarily in the business of processing coal mined by Glen Nan from the Newport Lands and selling such processed coal on both the wholesale and retail markets.

For the fiscal year ended September 30, 1962, Susquehanna timely filed its Federal income tax return with the district director of internal revenue, Scranton, Pennsylvania. For the fiscal year ended September 30, 1963, it timely filed its return with the district director of internal revenue, Philadelphia, Pennsylvania.

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3. Pursuant to a plan of liquidation adopted July 3, 1968, Glen Nan Coal Co., Inc. discontinued doing business and distributed all of its properties and assets to its sole shareholder, Glen Nan Coal Co., a partnership. Without objection on the part of respondent, Glen Nan Coal Co. has been substituted as petitioner in Docket No. 5032-68. Since July 8, 1968, the partnership has conducted the business previously carried on by the corporation from offices located in Wilkes-Barre, Pennsylvania.

Gap Anthracite Co. (hereinafter referred to as Gap), the petitioner in Docket No. 726-68, had its principal office at Nanticoke, Pennsylvania, at the time of the filing of its petition herein. It filed its Federal income tax return for the calendar year 1961 with the district director of internal revenue at Scranton, Pennsylvania. For the fiscal years ended September 30, 1962 and September 30, 1964, it filed its returns with the district director at Philadelphia, Pennsylvania.

Issue 1. Depletion Issue

FINDINGS OF FACT

On or before June 30, 1958, Glen Alden Corporation (hereinafter referred to as Glen Alden) was the owner of Newport Lands.

The M. A. Hanna Company (hereinafter referred to as Hanna), a predecessor of Susquehanna, was a large coal mine operator. During the 1950's, it was pursuing a long-term policy of divesting itself of coal mining operations and limiting itself to selling coal. Some time prior to June 17, 1958, Hanna had abandoned operation of its Glen Lyon breaker, which was located near the Newport Lands.

Biscontini, at this time, was engaged in mining and stripping coal from various properties owned by Hanna and Glen Alden, including the Newport Lands. However, in 1958, stripping work was becoming scarce, mines were "playing out," and, as a result, Biscontini was running out of work. Biscontini considered purchasing the Newport Lands to remedy this situation, but felt that Glen Alden would not deal with it because of its small size and because Glen Alden considered Biscontini to be only a contractor.

C. A. Gibbons, who headed the Susquehanna Collieries Division of Hanna, and Laurence Biscontini, a partner in Biscontini, were close friends and, at some

point prior to June 17, 1958, they discussed the purchase of the Newport Lands from Glen Alden in light of all of the aforementioned circumstances and the aspirations of Hanna and Biscontini.

Biscontini and Hanna subsequently entered into a series of agreements relating to the purchase of the Newport Lands and the sale of the coal produced therefrom.

The General Agreement, dated June 17, 1958, recited that Hanna was purchasing the Newport Lands from Glen Alden for $1,600,000,[4] with Hanna paying $275,000 down and giving a mortgage of $1,325,000, payable at $40,000 per year minimum plus 20 cents a ton on all coal mined and sold from the property above 200,000 tons in any one year. The General Agreement provided that Biscontini was to advance Hanna $275,000 (it subsequently did so) "as down payment on the purchase price which Hanna is making to Glen Alden Corporation for said property" and pay all taxes on the property. Hanna agreed to deliver a quitclaim deed of the Newport Lands to Biscontini on September 1, 1961, and Biscontini "agree[d] to assume the obligations of the aforesaid Mortgage." Hanna reserved the right to be the exclusive sales agent for all coal produced from the property until exhaustion and required that

> an Agreement to that effect shall be recorded or a provision be inserted in the Deed which so far as possible shall have the effect of a covenant running with the land."[5]

Hanna also agreed to convey certain surface rights to Biscontini at the latter's request provided Biscontini built

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4. This figure was arrived at by multiplying 20 cents times the estimated 8,000,000 tons of coal believed to be present on the Newport Lands.

5. Such a provision was included in the deed executed by Anthracite and Susquehanna in favor of Glen Nan, dated January 1, 1965.

a new breaker on the property and paid Hanna a royalty of 2½ cents per ton on all coal processed at the site. The General Agreement further provided that if Biscontini defaulted upon the mortgage and Glen Alden commenced foreclosure proceedings, Biscontini would convey the Newport Lands to Hanna, subject to the mortgage, for $1.00.

The $275,000 furnished by Biscontini was made the subject of an escrow agreement, which provided that it was to be returned to Biscontini if the agreement for the acquisition of the Newport Lands from Glen Alden was not completed.

Simultaneous with the General Agreement, Hanna and Biscontini executed a supplementary agreement reciting Hanna's undertaking to convey to Biscontini the Newport Lands being acquired from Glen Alden and providing that the General Agreement be amended to provide "that Biscontini, or his assignee, shall assume to Glen Alden the obligations in the mortgage between Glen Alden and Hanna."

Also on June 17, 1958, Hanna, through its Susquehanna Collieries Division, entered into an Operating Agreement with Biscontini which was to remain in effect until August 31, 1961. Biscontini was to assume generally all costs of mining and delivering coal from the Newport Lands to Hanna's Glen Lyon breaker and was to receive a flat rate of $18 per 100-cubic-foot mine car. In addition, Biscontini agreed to reimburse Hanna on a quarterly basis for real estate taxes on the Newport Lands and to pay Hanna a minimum of $40,000 per year plus 20 cents per gross ton over 200,000 tons on all coal mined from the Newport Lands; a contemporaneous agreement provided that Hanna would apply all such payments to the Glen Alden mortgage. Hanna retained a sizeable number of controls under the Operating Agreement, including the rights to suspend work by Biscontini; to terminate the agreement on two weeks' notice for cause (that determination being at the sole discretion of Hanna); to suspend production as Hanna's business conditions required; to

inspect the operation at any time in order to be sure Biscontini was complying with the terms of the agreement; to terminate the agreement on account of specified financial difficulties of Biscontini or adverse action on Biscontini's part; and to terminate the agreement if the operations proved unprofitable to Hanna. Biscontini agreed to surrender the premises to Susquehanna upon the termination of the agreement "in any way or from any cause or causes." The Operating Agreement prohibited the assignment or other disposition by Biscontini of its rights thereunder, but, by a contemporaneous agreement, Hanna consented to its assignment to a corporation controlled by the Biscontini family. It further provided that the various provisions for approval or direction of Hanna were not to constitute "control or management" by the latter. A Sales Agreement, also dated June 17, 1958, granted Hanna the exclusive right to sell coal as long as it was produced from the Newport Lands at a 5½ percent commission.[6]

Glen Alden insisted that the down payment be $375,000. Hanna loaned Biscontini $100,000, which was then paid to Glen Alden as part of the down payment. Biscontini gave Hanna a $100,000 note, dated June 30, 1958, bearing 4 percent interest per annum and due September 1, 1961.[7] The payment of the note was made "a condition precedent to the carrying out of said agreement to transfer said property to Borrower."

On June 30, 1958, Glen Alden deeded the Newport Lands to Hanna for a purchase price of $1,600,000, payable as described hereinabove. The mortgage (in the amount of $1,225,000 bearing no interest and with a right of anticipation) provided that Hanna could sell the property and assign the mortgage thereon without

6. The Sales Agreement itself contained no effective date. However, it appears that it was not to take effect until Hanna delivered the deed to Biscontini; none of the parties argues otherwise.

7. Although Biscontini and Hanna extended the date of payment to July 1, 1964, Glen Nan, Biscontini's successor-in-interest, paid the note off on October 10, 1961; interest was waived.

recourse by Glen Alden if (1) Hanna retained the exclusive rights to sell all coal produced from the Newport Lands and (2) the assignee agreed to be legally bound by the terms and conditions of the mortgage.

After June 30, 1958, Biscontini, and, later, Glen Nan, continued to mine and deliver coal from the Newport Lands to the Glen Lyon breaker. The price per cubic foot varied from time to time in accordance with subsequent agreements between Hanna, Biscontini, and their successors, in order to take into account the competitive situation in the coal industry.

On October 29, 1958, Hanna conveyed its Collieries Division, including its interest in the Newport Lands, to a wholly-owned subsidiary, Susquehanna Collieries Company (hereinafter referred to as Collieries), which assumed all of the obligations under the Glen Alden mortgage. Collieries then leased the property back to Hanna, under the terms of which lease Hanna agreed to pay Collieries a minimum "royalty" of $3,333.33 per month (or the equivalent of 20 cents per ton on 16,667 gross tons) and 20 cents per ton on tonnage in excess of the 16,667 gross tons mined in any month. Simultaneously, Hanna entered into an agreement with Collieries under which the latter designated Hanna as the sales agent for the coal. On January 2, 1959, Hanna and Collieries entered into an agreement designating Collieries as the operator of the mining activities on the property. The agreements between Hanna and Collieries were in substance counterparts of the agreements between Hanna and Biscontini. On February 25, 1959, Collieries' name was changed to Susquehanna Anthracite, Inc. (hereinafter referred to as Anthracite).

On November 2, 1958, Glen Nan was incorporated and all of Biscontini's interest in the agreements with Hanna was orally assigned by Biscontini to Glen Nan, subject to all liabilities and obligations of Biscontini under the agreements. This assignment was reduced to writing on April 2, 1962.

In July of 1959, it became apparent that Biscontini's successor, Glen Nan, did not have sufficient capital to build a new breaker and that the Glen Lyon breaker was in need of repair. Also, the Operating Agreement was much more lucrative to Hanna than the benefits it would obtain under the Sales Agreement. Therefore, Hanna agreed to remodel the breaker in exchange for extensions of the various agreements previously entered into between the parties. Consequently, the General Agreement was amended to provide for delivery of the deed to the Newport Lands on July 1, 1964[8] and the Operating Agreement was extended to July 1, 1964.[9]

On September 30, 1961, Susquehanna entered into an agreement with Hanna, whereby Susquehanna acquired substantially all of the assets and assumed the principal liabilities of the Anthracite Division of Hanna, which included the outstanding stock of Anthracite and the lease and other agreements between Anthracite (formerly Collieries) and Hanna. The purchase price was $1,550,000.

In November of 1962, Glen Alden notified Hanna's successor, Susquehanna, that it was in default on the mortgage and that the present balance of $869,604.20 was due. Susquehanna transferred funds from a bank in Philadelphia to the First National Bank of Wilkes-Barre, borrowed $250,000 from the latter bank, and tendered a check for $869,604.20 to Glen Alden. Glen Alden refused the check on the ground that other monies were owed to it and instituted foreclosure proceedings against the property. Eventually, Glen Alden accepted the aforementioned check in satisfaction of the balance owed on the mortgage. The mortgage on the Newport Lands was then assigned by Glen Alden to the First National Bank of Wilkes-Barre on November 30, 1962 and held by the

8. This date was later extended to December 31, 1964 by an agreement dated April 1, 1964.

9. By agreement dated April 1, 1964, the agreement was extended to December 31, 1964.

bank in its name for the benefit of Susquehanna until satisfied in August 1970. Susquehanna never notified Glen Nan of these events prior to the deed to Glen Nan on January 1, 1964, and the mortgage then on record was not marked satisfied because Susquehanna wished to keep secret the extent of its liquid assets. In 1964, Susquehanna made a further payment of $47,500 to Glen Alden representing accrued interest on the $869,604.20.[10]

On January 1, 1965, Anthracite and Susquehanna executed a deed of the Newport Lands to Glen Nan without payment of any further consideration by the latter. The deed was expressly made subject to the Sales Agreement dated June 17, 1958 between Biscontini and Hanna.

From and after July 1, 1958, and continuing until August 1970, Hanna and its successors in interest deducted and withheld the amounts otherwise due and owing by them to Biscontini and its successors as follows:

(a) Sums totalling $1,225,000 were deducted and withheld at a rate of 20 cents for each gross ton mined and sold commercially from the Newport Lands, and

(b) Amounts equal to all taxes on the Newport Lands were deducted and withheld in accordance with tax rates then in effect.

During the period July 1, 1958 to August 17, 1970, sums totaling $1,225,000 were paid or applied in reduction of the mortgage on the Newport Lands.

Hanna and its successors in interest regularly notified Biscontini and Glen Nan of payments on the

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10. The record is silent as to how the amount of interest was determined. In view of the fact that the mortgage itself was non-interest-bearing, it presumably represented compensation to Glen Alden for not having received the mortgage principal payments on the due dates.

mortgage as well as of payments of taxes on the Newport Lands.

The books and records of Biscontini reflect the transactions dealing with the Newport Lands in the following manner:

(a) The acquisition of the Newport Lands was recorded by a debit to an account captioned "Coal Lands" in the amount of $1,600,000 and credits totalling $1,600,000 to accounts captioned "Cash" ($275,000), "Loan Payable—Susquehanna Collieries Division, The M. A. Hanna Company" ($100,000), and "Loan Payable on Purchase of Coal Lands" ($1,225,000).

(b) Amounts deducted by Susquehanna (and its predecessors in interest) from amounts otherwise due and owing to Biscontini as set forth above were debited to the account captioned "Loan Payable on Purchase of Coal Lands."

(c) A payment in the amount of $100,000 made by Glen Nan on October 10, 1961, to Hanna was debited to the account captioned "Loan Payable -Susquehanna Collieries Division, The M. A. Hanna Company," thereby closing out said account.

(d) The amounts deducted by Susquehanna Coal Company (and its predecessors in interest) from amounts otherwise due and owing to Glen Nan Coal Co., Inc. (its predecessor and successor) for the payment of taxes were debited to an account captioned "Real Estate Taxes—Expense."

The books and records of Hanna reflect the acquisition of the Newport Lands by a debit to an account captioned "Depletable Property" in the amount of $1,600,000 and a credit to accounts captioned "Mortgage Payable" ($1,225,000) and "Accounts Payable-Suspense" ($375,000).

The books and records of Anthracite (formerly Collieries) reflect the transactions dealing with the Newport Lands as follows:

(a) The assignment of the Newport Lands from Hanna to Anthracite was recorded by a debit to an account captioned "Depletable Property Purchased —Coal Lands Assigned to Susquehanna Collieries Division Re Glen Alden Lands" in the amount of $1,600,000 and credits totaling $1,600,000 to accounts captioned "Mortgage Payable" ($1,225,-000) and "Accounts Payable—Suspense" ($375,-000).

(b) Amounts deducted by Anthracite, from amounts otherwise due and payable to Glen Nan (and its predecessor) were debited to the account captioned "Mortgage Payable" and credited to the account captioned "Depletion Accrued Re Glen Alden Purchase."

(c) The payment of Susquehanna (and its predecessors in interest) of all taxes on the Newport Lands to the appropriate authorities was recorded.

When Susquehanna paid Glen Alden $869,604.20 in satisfaction of the latter's mortgage, it debited an account entitled "Mortgages Payable" and credited cash. Prior to January 1, 1965, payments received from Glen Nan on account of the mortgage were recorded as royalty income by Susquehanna and an account representing Glen Nan's liability to Susquehanna on account of the mortgage was credited. After January 1, 1965, the characterization of these payments as royalty income was changed so that payments received on account thereof were debited to cash and credited to an account representing Glen Nan's liability to Susquehanna.

In computing the limitation for percentage depletion based on gross income as provided under section 613 of the Internal Revenue Code of 1954, as amended, Susquehanna excluded from gross income, for all taxable years

herein involved, amounts paid or credited to Glen Nan for coal mined from the Newport Lands.

In its original tax returns for fiscal 1962 and 1963, Susquehanna claimed no depletion in respect of the Newport Lands. In amended returns for those years and in its return for fiscal 1964, it claimed depletion on the amounts derived from the sale of coal from the Newport Lands after deduction of the amounts paid or credited to Glen Nan. By way of amended petition herein, Susquehanna now claims depletion on the gross amount derived from the sale of such coal without reduction for amounts paid or credited to Glen Nan.

For each taxable year, Glen Nan and its predecessor, Biscontini, reported as "income from coal sales from the Newport Land" the total amounts actually received by it from Susquehanna (and its predecessors in interest) during the year plus amounts deducted and withheld by them and took depletion on these amounts.

OPINION

At the outset, it will be useful to outline the nature of the dispute herein. Susquehanna argues that it, and not Glen Nan, had the requisite "economic interest" in the Newport Lands and that consequently it alone is entitled to the depletion deduction. Susquehanna makes the alternative argument that, in any event, it is entitled to a depletion deduction in respect of the amounts it received from its disposition of such coal after deduction for amounts paid by it to Glen Nan. Glen Nan's primary position is that it, and not Susquehanna, had the requisite "economic interest" and that consequently it alone is entitled to the depletion deduction. Alternatively, Glen Nan asserts that, even if Susquehanna is found to have such "economic interest," it (Glen Nan) also had a sufficient "economic interest" to justify the allowance of a deduction for depletion in respect of the amounts received by it from Susquehanna.

Respondent's position is essentially that of a stakeholder. He asserts that either Susquehanna or Glen Nan is entitled to the depletion deduction in respect of the Newport Lands and on brief he has indicated that he believes that Glen Nan has the better claim.[11] He further insists that under no circumstances are Susquehanna and Glen Nan entitled to percentage depletion on the same income–a point of view which the parties do not dispute and with which we agree. *Parsons v. Smith*, 359 U.S. 215, 220 (1959).

There is no dispute as to the amounts involved, nor as to the treatment of any of the items in question aside from the right to the percentage depletion deduction.

Section 611(a)[12] provides for a "reasonable allowance for depletion * * * according to the peculiar conditions in each case." As the Supreme Court pointed out in *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 312 (1956); the allowance "is designed to permit a recoupment of the owner's capital investment in the minerals, so that when the minerals are exhausted, the owner's capital is unimpaired." See also *Parsons v. Smith, supra.*

The necessary prerequisite to such an allowance is that the taxpayer must have an "economic interest" in the mineral in place. *Palmer v. Bender*, 287 U.S. 551 (1933); *Charles P. Mullins*, 48 T.C. 571, 579 (1967). The dual test of an "economic interest" has been delineated as follows by the Supreme Court in *Commissioner v. Southwest Exploration Co., supra:*

> In upholding the taxpayer's right to depletion on all such income, the Court [in *Palmer v. Bender, supra*] based its decision on the grounds that a taxpayer is entitled to depletion where he has: (1) "acquired, by

11. Respondent also agrees that if Glen Nan is not entitled to any deduction for depletion, it is entitled to deduct, as a business expense, the 20-cents-per-ton payments made to Susquehanna in amounts as to which respondent and Glen Nan are in agreement.

12. All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise specified.

> investment, any interest in the oil [coal] in place" and (2) secured by legal relationship "income derived from the extraction of the oil [coal] to which he must look for a return of his capital." [350 U.S. at 313-314.]

See also *Whitmer v. Commissioner*, 443 F.2d 170, 172 (C.A. 3, 1971), affirming a Memorandum Opinion of this Court; section 1.611-1(b)(1), Income Tax Regs.

The Supreme Court has also recognized that more than one taxpayer may have sufficient "economic interest" to justify an allowance for depletion to each, provided that the allowance is not duplicative in respect of the income from the property. See *Parsons v. Smith, supra*, 359 U.S. at 220.

Whether a taxpayer has an "economic interest" is "ultimately a question of fact based on the totality of facts in each case." *Leland Adkins*, 51 T.C. 957, 965 (1969). The particular legal terminology used by the parties is not controlling; moreover, technical title to the minerals in place is not important, nor is it a matter of consequence whether, under state law, the transaction is properly characterized as a sale, lease, or otherwise. *Palmer v. Bender, supra; J. Bryant Kasey*, 33 T.C. 656, 659 (1960).

It is against the background of the foregoing principles, which are easier to state than apply, that we turn to a consideration of the particular facts herein. We deal first with the status of Glen Nan (and its predecessor in interest, Biscontini). Susquehanna contends that, prior to January 1, 1965, Glen Nan was merely a mining contractor in its employ and that, consequently, *Paragon Jewel Coal Company v. Commissioner*, 380 U.S. 624 (1965), and *Parsons v. Smith, supra*, demand a decision herein that Glen Nan did not have an "economic interest" in the Newport Lands. Susquehanna points to the following facts as supportive of its position: the deeds from Glen Alden in the name of Hanna and, afterwards, from Hanna to Anthracite; the strong controls over the mining operation retained by Susquehanna in the Operating Agreement, particularly the power to terminate Glen Nan's mining activities and oust

it under certain circumstances; the satisfaction by Susquehanna of the outstanding balance on the mortgage held by Glen Alden in 1962 without any contribution by Glen Nan and the payment of accrued interest in respect of the amount paid; the fact that the Newport Lands were Susquehanna's only security in the event of Glen Nan's possible default on any of its obligations; the payment of a flat price per ton to Glen Nan and the consequent alleged subjection of Susquehanna to the risks and vagaries of the marketplace; Susquehanna's obligation to make payments on the mortgage and Glen Nan's obligation to convey the property to Susquehanna for $1.00 in the event of Glen Nan's default on the mortgage; and, finally, Susquehanna's exclusive right to sell all coal mined from the Newport Lands even after its conveyance to Glen Nan.

Glen Nan's position, of course, is diametrically opposed to the one taken by Susquehanna. It contends that, after all the smoke is cleared, it should be treated as the owner of the Newport Lands and that Susquehanna (and its predecessors in interest) should be held to be merely processors with nothing more than an economic advantage derived from the property. See *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938). It emphasizes the fact that Biscontini was the instigating party in the purchase and that all of the money for the down payment and subsequent payments of the purchase price came from either Biscontini or Glen Nan rather than Susquehanna.

We see no need to elaborate the fine distinctions that have been articulated in the decided cases, particularly with reference to the right to depletion on the part of so-called mining contractors. As we have previously pointed out (see page 22, *supra*), each case turns on its own facts. The down payment of $375,000, made to Glen Alden, was supplied by Biscontini, with the escrow agent directly responsible to Biscontini in respect of $275,000 thereof.[13]

13. To be sure, $100,000 of the down payment was obtained from Hanna by way of a loan, but the latter received an interest-bearing note therefor. In this connection, we note that Susquehanna's

While, in form, Hanna undertook to make the mortgage payments to Glen Alden, initially directly to Glen Alden and later through Anthracite (by virtue of Anthracite's assumption of the mortgage and Hanna's obligation under the lease from Anthracite), both the General Agreement and the Operating Agreement imposed the obligation to supply the precise amount of funds required upon Biscontini and, later, Glen Nan. Moreover, by a contemporaneous agreement, Hanna obligated itself to transmit to Glen Alden the funds so paid to it by Biscontini. It is also significant that Biscontini was obligated to pay the taxes charged against the property. See *Haddock Mining Company v. United States*, 92 F. Supp. 106, 109 (D. Pa. 1950); *Eastern Coal Corporation v. Yoke*, 67 F. Supp. 166, 175 (D.W. Va. 1946); see *Lesta Ramey*, 47 T.C. 363, 373 (1967), affd. 398 F. 2d 478 (C.A. 6, 1968). Finally, Biscontini and, later, Glen Nan were specifically obligated to accept transfer of title and formally assume the mortgage.[14]

We are unimpressed by the fact that Susquehanna prepaid the balance due Glen Alden on the mortgage in 1962. The record herein is deafeningly silent with respect to the reasons which underlay the necessity for such prepayment. It would appear that Susquehanna had failed properly to account to Glen Alden for the required tonnage payments and that conceivably this failure to account extended to funds which it had received from Glen Nan and should properly have been paid over to Glen Alden. Insofar

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Note 13—*Continued*

assertion that the rate of interest was substantially below the going rate of interest in the marketplace is utterly without foundation in the record and, in any event, would have little, if any, bearing on the issue involved herein. We also note that the interest on this indebtedness was waived at the time the principal was paid, for reasons unexplained in the record.

14. Indeed, the separate agreement of assumption, contemporaneously executed on June 17, 1958, appears to have overtones of *in praesenti* effect, since Biscontini had already agreed to assume the mortgage in the General Agreement.

as the interest payment by Susquehanna to Glen Alden is concerned, it seems obvious that this represented no more than compensation for moneys not paid when due; the mortgage itself was a non-interest-bearing obligation. See footnote 10, *supra*. It seems to us that if such payments were to be considered as creating an "economic interest" in Susquehanna at the expense of Glen Nan, it was incumbent upon Susquehanna, at the very least, to furnish us with a forthright explanation of the surrounding circumstances.[15] Finally, in this connection, we observe that Susquehanna kept the mortgage alive and clearly had the right to compel reimbursement from Glen Nan by way of the monthly payments and Glen Nan's assumption obligation.

Nor do we believe that the strict controls reserved to Hanna by the Operating Agreement operate to favor Susquehanna as against Glen Nan. As will subsequently appear, we have concluded that these controls merely served to protect Hanna's position as a financier-purchaser-coal processor, and not to confer upon it an "economic interest" in the coal in place. In any event, such controls, in our opinion, would not necessarily deprive Glen Nan of the "economic interest" which it had by virtue of the other elements involved.

We do not attach any particular importance, in light of all the other factors involved herein, to the fact that the Operating Agreement specified that Biscontini was to be paid a fixed price per ton of coal, especially since there is evidence that such price was modified from time to time by agreement of the parties to reflect competitive conditions in the coal industry. See *Paragon Jewel Coal Company v. Commissioner, supra*, 380 U.S. at 635.

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15. Susquehanna also asserts that a substantial portion of the purchase price paid by it to Hanna for the latter's Anthracite Division represented payment for the Newport Lands. The record is devoid of any probative evidence on this score; even the then balance of the Glen Alden mortgage in respect of which only Anthracite was obligated and which presumably was taken into account in determining the purchase price paid by Susquehanna is not revealed.

We are unable to accept Susquehanna's assertion that the transactions between Hanna and Biscontini should be construed as a mere contract to sell the property *in futuro* with the $375,000 supplied by the latter treated merely as an advance deposit on account of the purchase price, thus creating a "vertical slice" in respect of ownership, with Biscontini (and hence Glen Nan) entitled to depletion allowance only after the transfer of formal title. On the contrary, taking into account their obligations to make payments on account of the mortgage and taxes, together with the facts that Biscontini (and later Glen Nan) were in possession of the premises and had heavy responsibilities under the Operating Agreement, we construe the substance of the transactions as a sale *in praesenti* by Hanna to Biscontini with the payment of the balance of the purchase price deferred, with legal title being held by Hanna as security, and with, at most, a condition subsequent which would return substantive ownership to Hanna, and hence Susquehanna, upon default by Biscontini or Glen Nan. Cf. *Jefferson Gas Coal Co.*, 16 B.T.A. 1135 (1929), affirmed as to this issue, 52 F. 2d 120 (C.A. 3, 1931). In analogous situations, delay in the passage of legal title has not precluded a holding that a closed transaction occurred for purposes of determining the time of taxability of the proceeds of sale or that depreciation is allowable to the taxpayer even though he does not hold legal title. Compare, e.g., *Helvering v. F. R. Lazarus & Co.*, 308 U.S. 252 (1939); *Ted F. Merrill*, 40 T.C. 66 (1963), affirmed per curiam, 336 F. 2d 771 (C.A. 9, 1964); *North Carolina Lumber Co.*, 19 T.C. 587 (1952), reversed on another issue, 211 F. 2d 543 (C.A. 4, 1954); *E. J. Murray*, 21 T.C. 1049, 1062 (1954), affd. 232 F. 2d 742 (C.A. 9, 1956); *Marion A. Blake*, 8 T.C. 546 (1947).

In short, we conclude that Glen Nan had an "economic interest" in the Newport Lands and is entitled to an allowance for depletion in respect thereto. In reaching this conclusion, we have not taken into account the indications in the record (which are vague at best) that Biscontini may

have invested substantial sums in conveyor belts and pumps. Such an investment is not sufficient to support a finding of an "economic interest." *Parsons v. Smith, supra; William M. Legg*, 39 T.C. 30, 38-39 (1962).

We now turn to a consideration of whether Susquehanna had an "economic interest" so as to justify an allowance for depletion. Much of what we have said in our discussion relating to the position of Glen Nan militates against any such allowance to Susquehanna. Thus, we have already noted that funds for the purchase price payable to Glen Alden emanated from Biscontini and, later, Glen Nan. As to $100,000 of the down payment, Hanna was no more than a creditor. With respect to the prepayment of the balance of the mortgage (see pp. 26-27, *supra*), in our opinion, Susquehanna had *at best* the same status. Cf. *Bankers Mortgage Co.*, 1 T.C. 698 (1943), affirmed per curiam, 141 F.2d 357 (C.A. 5, 1944).

Of critical significance is the fact that the face amount of the mortgage was payable in all events.[16] Glen Nan was obligated to make the required mortgage payments and had assumed the liabilities of Biscontini (which included the latter's obligation in respect of the mortgage). The assumption agreements which Biscontini had executed could presumably have been specifically enforced against Glen Nan. Indeed, Susquehanna did not have any personal liability on the mortgage. Hanna had transferred the property and the mortgage to its wholly-owned subsidiary, Collieries (later Anthracite), and Susquehanna had simply acquired the stock of that subsidiary from Hanna. To be sure, Hanna (and, through it, Susquehanna) had undertaken to make payments in amounts equal to those due Glen Alden under the mortgage and the taxes on the premises, by virtue of the lease between Hanna and An-

16. The mortgage called for minimum payments of $40,000 annually plus amounts related to coal production. Concededly, in the absence of such production, the period of the payout would have been over 30 years, but this cannot obscure the fact that the principal sum was ultimately payable.

thracite. But, looking at the totality of the agreement, it is clear that Susquehanna ultimately had rights over against Glen Nan, i.e., it was no more than a guarantor of the mortgage. In this connection it should be noted that, as far as Glen Alden was concerned, it had no rights against Hanna or Susquehanna by virtue of Hanna's original assignment to Collieries (later Anthracite) in accordance with the "without recourse" clause in the mortgage. It could look only to Anthracite and Glen Nan by virtue of their assumption obligations and Anthracite had rights over and against Glen Nan via Susquehanna under the General Agreement and Operating Agreement. Thus, as we view the situation, legal title to the Newport Lands and Glen Nan's potential liability to reconvey remained in the Susquehanna complex merely as security for the fulfillment by Glen Nan of its personal liability to pay off the mortgage, make the tax payments, and perform its obligations under the Operating Agreement.[17] Clearly the foregoing circumstances are insufficient to create an "economic interest" in Susquehanna. Cf. *Anderson v. Helvering*, 310 U.S. 404 (1940). See also *Holbrook v. Commissioner*, 450 F.2d 134 (C.A. 5, 1971), reversing on other grounds 54 T.C. 1617 (1970), and cases cited therein. Concededly, if Glen Nan had defaulted on its obligations, Susquehanna could, and probably would, have taken over the operation of the Newport Lands and, in such a situation, might then have been able to claim such "economic interest." But the possibility of such "shifting use" *in futuro* does not support a present claim in this regard. Or, to put it another way, if, as Susquehanna asserts, there was a "vertical slice" in the ownership of those lands, Susquehanna, not Glen Nan, had the upper (or later) slice.

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17. It should be noted that the purchase price of the Newport Lands was geared directly to the estimated coal deposits. See footnote 4, *supra*. Consequently, the obligation of Glen Nan to reconvey for $1.00 had no independent significance. The coal was to produce the funds to pay the purchase price, Glen Nan had the liability to make the mortgage payments, and it looked to its mining of the coal to supply those funds.

Nor do any of the other elements of Susquehanna's position justify the conclusion that it had an "economic interest" in the Newport Lands. Its role as the purchaser, processor, and seller of the coal production will not support a finding of such an interest, since it is clear that such role was not an essential part of the extraction process. Cf. *Helvering v. Bankline Oil Co., supra; Utah Salt Co. v. Wise*, 370 F.2d 976 (C.A. 10, 1967); *CBN Corporation v. United States*, 364 F.2d 393 (Ct. Cl. 1966). Compare *Food Machinery and Chemical Corp. v. United States*, 366 F.2d 1007 (Ct. Cl. 1966) and 348 F.2d 921 (Ct. Cl. 1965). Similarly, Susquehanna's claims as to "vast" investments in the breaker installation (as to which the record, in any event, contains only the vaguest references) are beside the point. *Usibelli v. Commissioner*, 229 F.2d 539 (C.A. 9, 1955), affirming a Memorandum Opinion of this Court.

We have no doubt that the financial, processing, and sales capabilities of Hanna, and, later, Susquehanna, were important in enabling Biscontini, and, through it, Glen Nan, to acquire and successfully operate the Newport Lands. But economic power is not to be equated with "economic interest". Herein lies the fallacy of Susquehanna's position.

We hold that Susquehanna did not have an "economic interest" in the Newport Lands coal and therefore is not entitled to any depletion allowance.

In view of our conclusions, we need not consider the alternative arguments of Susquehanna and Glen Nan.

Issue 2. Workmen's Compensation Payments

FINDINGS OF FACT

All of the facts relevant to this issue have been fully stipulated.

On or about September 30, 1961, Susquehanna entered into an agreement with Gap whereby Gap was to operate one of Susquehanna's coal processing plants in

Pennsylvania known as the Glen Burn Breaker. The agreement provided, in part, as follows:

> (4) Gap shall pay all costs of operations of every nature and description in connection with the securing and preparation of said coal, including but not confined to Workmen's Compensation Insurance and Occupational Disease Insurance.
>
> (5) Susquehanna agrees to pay to Gap in full compensation for all charges, including costs of every description, excluding depreciation and depletion, the actual out-of-pocket expenses paid by Gap in the performance of this obligation, plus two (2¢) cents a net ton for all coal No. 3 Buck and above which shall be prepared and sold from the breaker. It is distinctly understood that Susquehanna does not guarantee any debts or obligations of Gap and does not make itself responsible to any third person or persons.
>
> (6) Settlement for all costs shall be made on the 15th day of each month for the preceding month except Vacation Pay which shall be advanced to Gap when due to be paid out by Susquenanna approximately June 25th to 30th each year, upon statement rendered and certified by Gap to Susquehanna at the office of Susquehanna this statement, unless excepted to by Susquehanna within ten (10) days, shall be final, binding and conclusive on both parties and subject to no additions, subtractions, corrections or retroactive charges or credits in favor of or against either party hereto.
>
> * * * * *
>
> (10) Gap does hereby assume and agree to assume, so far as Susquehanna is concerned, the liability for all injury or damage done to or suffered by any persons or property in connection with the possession or operation of the property by Gap under this Agreement and does hereby further agree to hold

Susquehanna harmless and indemnify it against any claims in connection therewith.

(11) This Agreement may be terminated on thirty (30) days written notice by either party to the other, sent by Certified Mail to the appropriate office. * * *

The amount of liability in each accident or disability case arising within the framework of Pennsylvania's workmen's compensation laws is determined by the State Workmen's Compensation Board and becomes a definite liability at that time. Payments are made monthly over a period of years.

Prior to Gap's taxable year ended September 30, 1964, Gap deducted amounts for workmen's compensation claims through the payroll account when actually paid and Susquehanna reimbursed Gap for these payments on the 15th day of the following month.

On February 26, 1964, Gap suffered a mining mishap in which three of its employees were killed. As of September 30, 1964, Gap owed approximately $40,000 for this accident on account of workmen's compensation claims, none of which was due to be paid until after that date. The total workmen's compensation claims accrued for fiscal year 1964 were as follows:

Claims from	*Amount*
1961	$ 486
1962	1,823
1963	14,533
1964	45,234
	$62,076

For the month of September of 1964, Gap billed Susquehanna $62,076.48 as "Workmen's Compensation Claims Determined"; Susquehanna deducted this amount on its fiscal 1964 return, in which it showed a net operating loss of $305,613.99. Gap accrued the charge to Sus-

quehanna as income and the liability in an equal amount as an expense on its own fiscal 1964 return, on which it claimed aggregate deductions of $758,244.66.

Prior to fiscal 1964, Gap's workmen's compensation claims were relatively insignificant and were deducted by Gap and Susquehanna on the cash basis of accounting. With this exception, both Susquehanna and Gap filed their Federal income tax returns using the accrual method of accounting.

In its notice of deficiency to Susquehanna, respondent stated:

> Workmen's compensation-Gap Anthracite Co. deducted in the amount of $62,076.48, for the taxable year ended September 30, 1964, is disallowed as permission of the commissioner was never obtained in changing the method of accounting.

The notice of deficiency sent to Gap stated, in relevant part, as follows:

> It is determined that since the cash method of accounting was adopted by you with respect to workmen's compensation insurance claims, the deductions allowable for such claims are limited to the amounts actually paid.

OPINION

Section 446(e) provides, in effect, that a taxpayer cannot change his method of accounting for reporting taxable income without the prior consent of the Commissioner. Section 1.446-1(e)(2)(ii)(a), Income Tax Regs., defines the term "method of accounting" as not only the overall method used by the taxpayer but also that used for the treatment of any material item. According to respondent's regulations, a material item is "*any* item which involves the proper time for the inclusion of the item in income or the taking of a deduction." [Emphasis added.] Section 1.446-1(e)(2)(ii)(a), Income Tax Regs. A change

in the underlying facts of a situation will not be considered a change in accounting method. Section 1.446-1(e)(2)(ii)-(b), Income Tax Regs.; *Decision, Inc.*, 47 T.C. 58 (1966).

The resolution of the issue before us has two components. First, petitioners contend that the change by Gap in its billing method to include liability for accrued but unpaid workmen's compensation, and Susquehanna's action in respect thereto, constituted a modification of the 1961 agreement and therefore a change in the underlying facts rather than a change in accounting method within the meaning of section 1.446-1(e)(2)(ii)(b) of respondent's regulations and our holding in *Decision, Inc., supra.* Second, they contend that, even if a change of accounting method was involved, it did not relate to a material item. Petitioners concede that, if we find that a change of accounting method as to a material item was involved, they did not obtain the prior consent of the Commissioner under section 446(e), which they were required to do. Respondent urges us to reject both contentions of petitioners. We agree with respondent.

The 1961 agreement between Susquehanna and Gap clearly provided that the former was to pay the latter for its "out-of-pocket expenses." Quite clearly, therefore, Gap was not entitled to reimbursement and no amount was due and payable by Susquehanna until Gap had actually made an expenditure. The only exception was in respect of vacation pay, which was to be advanced by Susquehanna "when due." The record herein merely shows that (a) Gap unilaterally decided to change its billing procedure and (b) Susquehanna took a deduction for the amount billed. We have been furnished with no evidence that Susquehanna agreed to the change in Gap's billing procedure either by notifying Gap of its acquiescence or by payment within the time contemplated by the agreement. The only thing we know is that Susquehanna took a deduction on its tax return. For aught that appears, Susquehanna still did not consider itself liable for the payment until Gap actually made an expenditure on a claim.

We are unable to conclude, therefore, that there was such mutuality of assent to a changed procedure as to constitute a change in business policy rather than a change of accounting method. See *Decision, Inc., supra*, 47 T.C. at 64. All of the Pennsylvania cases relied upon by petitioners involved a clear assent by the party to be bound, which either was disclosed directly to the other party or arose from a continuous course of action amounting to a waiver.

We are reinforced in our analysis by the contrasting care which was taken by Gap and Susquehanna to establish an accrual basis for reimbursement in the case of vacation pay. We also note that, absent any other explanation, the only reason for the change appears to have been to enable Susquehanna substantially to increase its net operating loss; as far as Gap was concerned, the transaction produced a "wash," whichever method was utilized. See *Decision, Inc., supra*, 47 T.C. at 64; *E. Morris Cox*, 43 T.C. 448, 457, n. 3 (1965).

In view of the foregoing, we hold that a change of accounting method occurred.[18]

We turn now to the question whether the liability for workmen's compensation claims constituted a material item within the meaning of respondent's regulations. Section 1.446-1(e)(2)(ii)(a), Income Tax Regs., was adopted in its present form in November of 1970, although it applies to all taxable years beginning after December 31, 1953. T.D. 7073, 1970-2 C.B. 98. Prior to this time, respondent's regulations did not contain a precise definition of the term "material item," which term appears in the Congressional reports accompanying the passage of section 446(e) in 1954. See S. Rept. No. 1622, 83d Cong., 2d Sess., p. 300

18. We see no purpose to be served in discussing respondent's argument that Susquehanna was, in any event, not liable to reimburse Gap in respect of workmen's compensation claims by virtue of paragraph (10) of the agreement. Consideration of such argument would involve problems comparable to those involved in squaring the circle.

(1954); H. Rept. No. 1337, 83d Cong., 2d Sess., p. A158 (1954). See also *Dorr-Oliver, Inc.*, 40 T.C. 50, 53-54 (1963).

We need not now decide whether respondent's regulations encompassing "any item" should be applied under all circumstances. The amount involved, i.e., $62,076.48, is certainly substantial in absolute terms. Moreover, it is substantial insofar as Susquehanna is concerned in that it represents over 20 percent of its claimed net operating loss for the taxable year in question, or, to put it another way, increases that loss by over 25 percent. With respect to Gap, it represents more than 8 percent of its claimed deductions for such taxable year. Under these circumstances, we hold that the item was "material." Cf. *Hackensack Water Co. v. Commissioner*, 352 F.2d 807, 810 (Ct. Cl. 1965); *Broida, Stone & Thomas, Inc. v. United States*, 204 F. Supp. 841 (D. W. Va. 1962), affirmed per curiam, 309 F.2d 486 (C.A. 4, 1962); *Dorr-Oliver, Inc., supra*, 40 T.C. at 55. See section 1.446-1(e)(2)(iii), Example (2). Similarly, under such circumstances, we consider the fact that the amounts involved in such item in past years were small an irrelevant consideration.

One final word. Respondent has conceded that Gap should not be required to accrue the $62,076.48 in income if Susquehanna is not entitled to a deduction therefor. Our reasoning accords with this concession and the amount therefor should be eliminated from Gap's gross income.

To reflect our conclusions herein as well as the various concessions of the parties on other issues,

Decisions will be entered under Rule 50.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 73-1283

SUSQUEHANNA COAL COMPANY,
Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

Argued October 25, 1973

Before McLAUGHLIN, HASTIE and GIBBONS,
Circuit Judges

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OPINION OF THE COURT

(Filed November 21, 1973)

PER CURIAM

In this appeal from a decision of the Tax Court, the taxpayer, Susquehanna Coal Company (Susquehanna) asks us to reverse that court's determination that for the years 1962 through 1964 Susquehanna did not have such an interest in coal in place as to permit it a percentage depletion deduction pursuant to 26 U.S.C. §611(a), (b). Relevant parts of that statute provide:

> §611. Allowance of deduction for depletion
>
> "(a) General rule.—In the case of mines . . . there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion . . . according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. . . .
>
> (b) Special rules.—
> (1) Leases.—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee."

Implementing these sections the Secretary has issued Treasury Regulations on Income Tax (1954 Code) 26 C.F.R. §1.611-1 Allowance of deduction for depletion:

> "(b) Economic interest. (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits. . . . An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . . to which he must look for a return of his capital. . . . A person who has no capital investment in the mineral deposit . . . does not possess an

> economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction . . . does not convey a depletable economic interest."

The complex series of transactions by which Susquehanna succeeded to ownership of the contractual interest upon which it relies to justify its percentage depletion deduction is set forth fully in the Tax Court's memorandum decision. 31 TCM 924 (1972). For present purposes we need only observe that Susquehanna is the successor in interest to M. A. Hanna Company (Hanna) and that such interest is reflected in a group of interrelated agreements, made in 1958, between Glen Alden Corporation (Glen Alden), Hanna, and L. Biscontini & Sons (Biscontini). At that time Glen Alden owned the coal in place in the Newport coal lands. Hanna was in the business of selling coal but also owned a coal breaker convenient to the Newport coal lands. Biscontini was a coal mining contractor. Hanna had sufficient standing in the industry to negotiate with Glen Alden for purchase of the Newport coal lands, but was interested primarily in sales rather than in production. Biscontini did not have sufficient standing in the industry to negotiate with Glen Alden for the purchase of the Newport coal lands, but was interested in production from those lands. Hanna approached Glen Alden and arranged to purchase the Newport coal lands for $1,600,000, paying $375,000 down and the balance at a fixed payment of $40,000 a year, plus 20 cents a ton over two million tons a year mined. Biscontini agreed with Hanna that he rather than it would put up the down payment,[1] and that he would

1. Actually Hanna put up $100,000 of the down payment, but took a note from Biscontini for this amount which was repaid in due course.

assume the mortgage. Hanna also agreed that it would convey the coal lands to Biscontini on September 1, 1961. Biscontini and Hanna also entered into two other agreements. One, covering a period after the contemplated deed from Hanna to Biscontini made Hanna Biscontini's exclusive sales representative on a commission basis. That sales agreement is not in issue in this appeal. The other, denominated an operating agreement, and covering the period prior to the contemplated deed from Hanna to Biscontini, provided that Biscontini would mine the coal for Hanna, receiving a fixed price (subject to labor cost adjustments) per ton. It is the operating agreement which Susquehanna contends gave Hanna a sufficient economic interest to entitle it to a percentage depletion deduction.

Susquehanna concedes in this court that while the operating agreement was in effect and prior to the delivery of the deed for the coal lands Biscontini (and his successor Glen Nan) had such an economic interest in the coal in place as entitled him to a percentage depletion deduction against that part of the income flow from the sale of coal which went to him. Susquehanna urges, however, that Biscontini's economic interest did not necessarily preclude a similar deduction against that part of the income flow from the sale of coal which went to it, so long as it, too, had an economic interest in the coal in place. The operating agreement, it contends, gave Hanna, and it as Hanna's successor, such an interest because properly construed the 1958 transactions were the equivalent of:

(1) a purchase by Hanna from Glen Alden
(2) an immediate sale by Hanna to Biscontini, and
(3) an immediate lease back from Biscontini to Hanna.

The 1958 agreements may well be subject to such a sale and lease back construction. This, however, does not suffice. Under 26 C.F.R. §1.611(1)(b) a percentage depletion allowance is permitted if three factors are present. First, the taxpayer must have an interest in mineral in place. Second, he must have acquired such interest by invest-

ment. Third, he must look to income from the extraction of the mineral for the return of his capital.

Here no one except Biscontini made an investment in the mineral in place. Biscontini put up the down payment and unconditionally assumed the purchase money mortgage. The purpose of the percentage depletion deduction is to permit an investor in minerals in place to obtain a return of his capital investment in those minerals. A recognition of economic interests not involving investments in the minerals in place as sufficient to support a percentage depletion deduction would be inconsistent with that purpose.

Susquehanna urges, however, that the 1958 agreement (and a later amendment) required it to make capital improvements to its coal breaker, and that the coal breaker was an essential element in the entire scheme. Susquehanna did, of course, take depreciation deductions on the capital improvements to the coal breaker. Nevertheless, in reliance on *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956) and *Food Machinery and Chemical Corporation v. United States*, 348 F.2d 921 (Ct. Cl. 1965), it contends that the investment in breaker improvements sufficies to give it an economic interest in the coal in place.

In *Southwest Exploration Co.*, a drilling company contracted to develop certain oil deposits off the coast of California by slant drilling from sites located on property of adjacent upland owners. The Supreme Court held that the upland owners had an economic interest in the oil in place because it could not be reached except through their land. Susquehanna urges that this case is authority for eliminating the requirement for an investment in mineral in place. Clearly it is not, for the upland owners did have an investment in the uplands. The Court merely recognized that their ownership of the uplands gave them an interest in the adjacent minerals in place which could not otherwise be extracted.

The *Food Machinery* case is closer to Susquehanna's situation. There *Food Machinery* invested twenty million

dollars in four immovable electric furnaces at the site of a deposit of phosphate shale, and undertook to purchase shale from Simplot, the lessee of the land. Although there are a number of differences, factual and legal, between the Food Machinery and Chemical Corp-Simplot transaction on the one hand and the Hanna-Biscontini transaction on the other, some language in the opinion of the Court of Claims can be construed as recognizing the investment in the electric furnaces as the equivalent of an investment in the phosphate for percentage depletion purposes. The Court of Claims relied, for this interpretation of the Internal Revenue Code, on *Southwest Exploration Co.* To the extent that it recognizes that an investment in something other than mineral in place is sufficient for percentage depletion we believe the *Food Machinery* case misinterprets the *Southwest Exploration Co.* case and we decline to follow it. This case is controlled by cases such as *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624 (1965); *Parsons v. Smith*, 359 U.S. 215 (1959); and *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938).

The judgment of the Tax Court will be affirmed.

TO THE CLERK OF THE COURT

Please file the foregoing opinion.

Circuit Judge

United States Court of Appeals

FOR THE THIRD CIRCUIT

No. 73-1283

SUSQUEHANNA COAL COMPANY
W. H. MOORE, PRES.

v.

COMMISSIONER OF INTERNAL REVENUE

SUSQUEHANNA COAL COMPANY, *Appellant*

(T. C. Docket No. 4407-69)

ON APPEAL FROM A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: McLAUGHLIN, HASTIE and GIBBONS, *Circuit Judges*

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed. Costs taxed against appellant.

ATTEST:

Chief Deputy Clerk

November 21, 1973

United States Court of Appeals

FOR THE THIRD CIRCUIT

No. 73-1283

SUSQUEHANNA COAL COMPANY, *Appellant*,

v.

COMMISSIONER OF INTERNAL REVENUE

SUR PETITION FOR REHEARING

Present: SEITZ, *Chief Judge*, McLAUGHLIN, HASTIE, VAN DUSEN, ALDISERT, ADAMS, GIBBONS, HUNTER, WEIS and GARTH, *Circuit Judges*

The petition for rehearing filed by

APPELLANT

in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

Dated: December 21, 1973

Judge